Agenda Date: 4/26/06
Agenda Item: 2G

STATE OF NEW JERSEY

Board of Public Utilities
Two Gateway Center
Newark, NJ 07102
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ENERGY

IN THE MATTER OF ATLANTIC CITY ELECTRIC COMPANY'S PRIVATE LETTER RULING REQUEST SEEKING A FINDING THAT THE CONTINUED FLOW-THROUGH TO RATEPAYERS OF UNAMORTIZED INVESTMENT TAX CREDITS ASSOCIATED WITH CERTAIN DIVESTED GENERATING ASSETS WOULD NOT VIOLATE THE IRS' NORMALIZATION RULES	)	ORDER DOCKET NO. EO06040315

(SERVICE LIST ATTACHED)

BY THE BOARD:

As part of its May 10, 2000 Decision and Order in I/M/O the Petition of Atlantic City Electric Company ("ACE" or "Company") Regarding the Sale of Nuclear Assets Docket No. EM99110870 ("2000 Order"), the Board of Public Utilities ("Board" or "BPU"), approved the sale of ACE's minority interest in the Salem Nuclear Generating Station, Units 1 and 2, Peach Bottom Atomic Power Station, Units 2 and 3, and the Hope Creek Nuclear Generating Station, as well as the recovery of stranded costs. In its 2000 Order, the Board did not resolve, and specifically held open, the disposition of the Accumulated Deferred Investment Tax Credit ("ADITC") and Excess Deferred Income Tax ("EDIT") balances upon the transfer of the nuclear generation assets. The BPU's 2000 Order, consistent with the Board's prior Orders relating to other utilities' sales of generation assets, held this issue open and directed ACE to seek a private letter ruling ("PLR") from the Internal Revenue Service ("IRS" or "the Service") to determine whether or not the value of the Investment Tax Credits ("ITC") and EDIT could legitimately be credited to customers without violating the tax normalization policies of that agency. 2000 Order at 22. The BPU noted that its "final determination of the net proceeds and stranded costs (the post-closing true-up proposed by the Company (on page 26 of the petition) shall await the outcome of this ruling." 2000 Order at 22-23.

In accordance with the Board's 2000 Order directive, by letter dated December 12, 2002, Pepco Holdings, Inc. ("PHI") on behalf of its indirect wholly-owned subsidiary, ACE, requested a PLR from the IRS that the Company would not violate the requirements of the investment tax credit normalization rules set forth in former Code §46(f) if it credits to customers the ADITC and EDIT associated with the generating assets which have been sold. No final PLR has been issued by the IRS on this request to date.

By notice published at 68 Fed. Reg. 10190 (March 4, 2003), encaptioned "Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Generation Assets Cease To Be Public Utility Property," the IRS proposed regulations providing for the flow-through of Excess Deferred Income Taxes ("EDFIT") and ADITC, concluding that neither former section 46(f) nor section 203(e) of the Tax Reform Act suggest that EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers and that such flow-through therefore could occur without violating normalization rules. ("2003 Regulations"). The regulations were proposed to apply to property deregulated after March 4, 2003, and utilities could elect to apply the proposed rules to property that became deregulated generation property prior thereto. The Board filed comments in support of the proposed regulations.

On December 21, 2005, the Board initiated a generic proceeding (BPU Docket Nos. EX02060363, EX02060364, EX02060365, EX02060366) in order to formulate an appropriate regulatory treatment for ITC related to generation assets. Comments were solicited and received from the State's electric distribution companies, and the Division of the Ratepayer Advocate ("RPA").

Also on December 21, 2005, the IRS withdrew its March 4, 2003 proposed rulemaking and proposed new regulations by notice published at 70 Fed. Reg. 75762 (December 21, 2005), encaptioned "Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Assets Cease to Be Public Utility Property," with corrections published at 70 Fed. Reg. 76433 (December 27, 2005). ("2005 Rulemaking"). The IRS again concluded that such flow-through would not violate normalization requirements provided certain criteria are met and proposed to permit such flow-through, but limited, however, to plant that ceased to be public utility property after December 21, 2005, with certain exceptions for plant that ceased to be public utility property on or after March 5, 2003. The Board has commented on the proposed regulations and urged the IRS to make certain modifications thereto, including, among other things, elimination of the arbitrary time constraints for allowing the flow-through to ratepayers of unamortized investment tax credits and excess deferred income taxes associated with divested utility plant.

In April 2006, the IRS informed ACE that it was tentatively adverse to the 2002 PLR requested by ACE. On April 17, 2006, at the Company's request, and pursuant to IRS procedures, a Conference of Right was held by telephone with the IRS and ACE, along with representatives of the Board and the RPA. The IRS indicated that comments could be submitted within 21 days through ACE.

Thereafter, by telephone conference call on April 20, 2006, confirmed by letter dated April 21, 2006, the Board's Staff provided notice to the affected utilities and the RPA that this matter would be considered by the Board at its April 26, 2006 agenda meeting, and the Board's Staff anticipated it may recommend to the Board that, in light of the subsequent events described above, it reconsider prior directives to ACE, as well as directives to Jersey Central Power and Light Company ("JCP&L") and Public Service Electric & Gas Company ("PSE&G"), to seek private letter rulings from the IRS that the flow-through to ratepayers of unamortized investment tax credits and excess deferred income taxes associated with divested generation plant would not violate IRS normalization rules. The notice further indicated Staff may recommend that the Board revoke its aforementioned prior directives to seek PLRs and direct the utilities to withdraw their requests for PLRs from the IRS immediately, with the flow-through issue continuing to be

considered by the IRS in the context of its rulemaking, subject to judicial review. An opportunity for each utility and RPA to submit comments on whether these actions should be taken by the Board was provided. By the April 24, 2006 deadline, PSE&G, JCP&L, ACE and the RPA provided comments.

By letter received electronically on April 24, 2006, from Roger Pedersen, Manager New Jersey Regulatory Affairs for ACE ("ACE letter"), ACE objects to the potential Board action ordering withdrawal of the PLR request. ACE argues that a withdrawal of the ruling request would be a "de facto adverse private letter ruling" as the IRS would notify the appropriate local offices and would likely instruct them to challenge any return position inconsistent with the IRS' position on the Stranded Cost Reduction issue. ACE Letter at 3.

ACE further argues that if the BPU believes the IRS' proposed regulations, once final, are incorrect, an issued ruling will not impede or change any of the BPU's options or otherwise impair any legal challenges. According to ACE, an issued ruling will, however, provide guidance to ACE and the BPU on how to proceed in the event the BPU decides not to pursue the issue or in the event the BPU is unsuccessful in its efforts to challenge the regulation. ACE also notes the treatment of Accumulated Deferred Federal Income Taxes ("ADFIT") receives no further guidance in the IRS' proposed regulations beyond what is already available "and the issue will likely not be any clearer in the final regulations." ACE states, "An issued ruling would provide certainty with respect to this issue and appears to be the only way ACE can meet its requirements under the current order. Moreover, there is also no assurance that the Service would rule again on the Stranded Cost Reduction issue. To proceed without this guidance would be a mistake, as it could easily lead to making an incorrect assumption that will have extremely undesirable repercussions for New Jersey customers." ACE Letter at 4.

Atlantic City Electric sets forth certain "options" that the Board might consider, namely: 1) allow the PLRs to be issued; or 2) request that the IRS hold off on ruling adversely until the proposed regulations become final. ACE asserts that there are no administrative procedures available to "appeal" final regulations other than convincing the IRS to withdraw them. The only challenge would have to be done judicially and, in order to do so, the BPU would have to first cause a violation of the final regulations. By ordering flow-through of the ITC, the BPU would have to order ACE to purposefully violate the final regulations. ACE warns that this would cause a normalization violation, which it asserts would have severe consequences. The Company asserts that violation of normalization would require ACE to repay the ADITC for both the divested assets and retained assets, including the unamortized ADITC related to the transmission and distribution assets. ACE proposes that such consequences would increase ACE's cost of service to account for additional interest costs (for borrowings required to repay the money to the IRS), as well as an increase in ACE's income tax expense, as there will be no ADITC left to amortize. In addition, ACE posits that it would be disallowed accelerated depreciation, with respect to assets in service at the time of the normalization violation, likely on a permanent basis. ACE concludes by opining that any litigation challenging the regulations would "take years" and would be "unlikely to succeed." ACE Letter at 6. Thus, the Company requests that the BPU carefully consider its course of action, because "any challenge to the final regulations will have severe and immediate consequences to ACE and its customers." Ibid.

By letter dated April 24, 2006 from the RPA by Diane Schulze, Assistant Deputy Ratepayer Advocate ("RPA letter"), the RPA requests that the Board order PSE&G, as well as JCP&L and ACE, to immediately withdraw their PLR requests addressing the ITC issue due to the proposed IRS regulation on the issue. The RPA maintains that with the delay in the IRS responding to the PLR requests, circumstances have changed to make the rulings no longer necessary. The RPA

asserts that the "letter rulings are no longer necessary and may even be detrimental to obtaining clarification on the issue." RPA letter, at 7. The RPA asserts that the Board's directive to file for a PLR was made with the expectation of a timely IRS response, and when a response from the IRS was not forthcoming, and the Board was forced to make stranded cost determinations without IRS guidance. The RPA further argues that "issuance by the IRS of the proposed regulations effectively superseded any previous request for a private letter ruling" and in the interest of ensuring uniform treatment, the utilities should have withdrawn their requests with issuance of the March 2003 proposed regulations. RPA letter, at 8. The RPA contends that an adverse ruling at this late date will "severely limit" the Board's options in protecting ratepayers' interests, while if the PLR request is withdrawn, the Board would have the flexibility to await the IRS regulation and once the IRS' final position is public, to act accordingly. It also asserts that piecemeal determinations should be discouraged and the full IRS rulemaking should proceed before making a final determination on the ADITC reserves. Maintaining that the proper way to resolve the issues is through rulemaking, which includes both the opportunity for fair comment and standing to appeal, the RPA requests the Board to direct the utilities to immediately withdraw their requests for private letter rulings.

The Board has carefully considered the submissions of ACE and the RPA. The Board FINDS that its Staff, which is acting in an advisory capacity to the Board with regard to the PLR request and the IRS rulemaking, was not required to first file a formal motion consistent with the time constraints of a motion in a contested case. The PLR request is not a contested case before the Board. Nonetheless, Staff sent the letter to the affected parties in order to solicit their respective positions on this issue, so that they could be conveyed to and considered by the Board when it considers this issue. Moreover, because comments to the IRS are due by May 8, 2006, there is a need to consider this matter expeditiously. ACE has had an opportunity to provide its comments to the Board, and has, in fact, submitted detailed comments, such that any informality or irregularity has not impaired ACE's rights or interests.

The IRS has clearly recognized that the flow-through issues are appropriate for rulemaking by publishing two notices of proposed regulations, in 2003 and 2005. While the IRS has indicated that, before its 2003 proposed rulemaking, it had issued PLRs holding that flow-through of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, based on the principle that flow-through is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flow-through is permitted, after further consideration the IRS and the Department of Treasury have concluded that the relevant statutory provisions do not prohibit a utility from flowing through ADITC reserves after deregulation and EDFIT reserves with respect to deregulated utility property. 2005 Rulemaking, at 75763. As the IRS explained in its 2003 proposed rulemaking:

> After further consideration, the Service and Treasury have concluded that neither former section 46(f)(2) nor section 203(e) of the Tax Reform Act suggests that the EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers. Instead, Congress provided a schedule for flowing through the reserves so that utilities would have the benefit of cost-free capital for a predictable period.
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> [2003 Rulemaking, at 10191 (emphasis supplied)].

The statutory provisions that the IRS cited in the 2003 Rulemaking contemplated that the utilities would flow these monies through to ratepayers in accordance with a schedule, but

nothing in those provisions suggested that the utilities could turn "the benefit of cost-free capital for a predictable period" into a permanent benefit of cost-free capital without any obligation to pass that benefit along to the ratepayers.

Similarly, in its 2005 Rulemaking, the IRS explained its interpretation of the relevant statutory provisions:

> After further consideration, the IRS and Treasury have concluded that former section 46(f) does not, in all cases, prohibit flow-through of ADITC reserves after deregulation and that section 203(e) of the Tax Reform Act does not preclude flow-through of the EDFIT reserve with respect to deregulated property.
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> [2005 Rulemaking, at 75763 (emphasis supplied)].

As to the flow-through of ADITC reserves, the IRS further explained in its 2005 Rulemaking:

> If an asset qualifying for the investment tax credit is purchased by a utility, the allowance of the credit, without flow-through, lowers the utility's actual tax expense but does not result in higher tax expense for ratepayers than would have been the case if the asset had not been purchased. Thus, in the absence of flow-through, the investment tax credit is a subsidy from the Federal government for the purchase of the asset rather than a transfer from ratepayers to the utility. The underlying policy of former section 46(f) is to share this subsidy between ratepayers and utilities in proportion to their respective contributions to the purchase price. In general, former section 46(f) treats ratepayers as contributing to the purchase price when ratemaking depreciation expense with respect to the asset is included in the rates they pay, resulting in full flow-through over the asset's regulatory life. In the case of a deregulated asset, the contribution of ratepayers can be appropriately measured by the ratemaking depreciation expense they are charged with respect to the asset and any additional stranded cost that the utility is permitted to recover with respect to the asset after its deregulation.
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> [2005 Rulemaking, at 75763 (emphasis supplied)].

Accordingly, based on the IRS' interpretation of the relevant statutes and their underlying policy and intent, the proposed regulations would permit flow-through of the ADITC reserve with respect to public utility property to continue after its deregulation to the extent the reduction in cost of service does not exceed, as a percentage of the ADITC with respect to the property at the time of deregulation, the percentage of the total stranded cost that the taxpayer is permitted to recover with respect to the property. In addition, the credit may not be flowed through more rapidly than the rate at which the taxpayer is permitted to recover the stranded cost with respect to the property.

Although the 2003 proposed regulations would have permitted utilities to elect to apply the proposed rules to property that was deregulated on or before March 4, 2003, the 2005 Rulemaking proposed other provisions pertaining to the regulations' effective date:

> Comments suggested that deregulation agreements between utilities and their regulators entered into before the March 4, 2003 proposed effective date were

based on the only guidance then available (*i.e.* ,the private letter rulings issued by the IRS) and that the availability of a retroactive election could effectively change the terms of those agreements. Although private letter rulings are directed only to the taxpayers who requested them and may not be used or cited as precedent, the IRS and Treasury have concluded that the Secretary's authority under section 7805(b)(7) to provide for retroactive elections should not be exercised in a manner that impairs existing agreements between utilities and their regulators.

[2005 Rulemaking, at 75763 (emphasis supplied)].

As the Board explained in its comments on the proposed regulations, this proposed rationale for eliminating retroactivity simply does not apply to the situation in New Jersey. Although New Jersey's electric industry completed its deregulation prior to March, 2003, the Board specifically carved out the issue of proper treatment of ADITC in its restructuring orders, including the ACE restructuring order.

Thus, the Board's 2000 Order did not depend at all on any Private Letter Rulings that preceded it. On the contrary, the Board's 2000 Order left this issue open and directed ACE to seek a letter ruling from the IRS to determine whether or not the value of the ITC can legitimately be credited to customers without violating the tax normalization policies of that Agency to the detriment of the Company and the customers. .Accordingly, flow-through could be allowed without making any change in the terms of the Board's 2000 Order and without making any change in the basis for that order contemplated by the parties at the time it was issued, and without impairing any existing agreements between utilities and their regulators. The reasoning underlying the 2005 Rulemaking's effective date therefore is inapplicable to ACE's request and should be modified, as the Board submitted in its rulemaking comments to the IRS.

Notwithstanding its own proposal of rules in March 2003 to interpret the relevant statutory provisions, and its own proposal of rules again in December 2005, and its having afforded opportunities for interested parties to provide comments on the proposals for the IRS' consideration, the IRS apparently now seeks to issue interpretations through a series of private letter rulings addressing ACE, two other New Jersey utilities, Jersey Central Power & Light Company, and Public Service Electric & Gas Company, and possibly a number of other utilities as well. While the IRS has indicated that the Board and the RPA may submit comments on this issue by May 8, 2006, through the taxpayer utility, the IRS has asserted further that no such third party would have standing to contest a private letter ruling through judicial review. The IRS should not take action of such broad scope and applicability, with such a large financial impact on millions of ratepayers, through a piecemeal process that eliminates any real scrutiny on behalf of the many people affected by the action. The IRS should, as it is in the process of doing, resolve the outstanding questions by considering the comments of the Board and other interested parties and finalizing its proposed rulemaking, subject to such judicial review as may be appropriate. Were the IRS to issue a PLR without first completing its pending rulemaking, including that part of the rulemaking pertaining to the effective date for the IRS' statutory interpretations, it would vitiate the opportunity to be heard that was to be provided to the Board and other interested parties in the rulemaking, and would prematurely judge issues prior to their full and due consideration by the IRS pursuant to its own notice of rulemaking. Moreover, proceeding in such manner could result in disparate treatment depending on whether a public utility sought a PLR or is governed by the rulemaking. Such disparity would be particularly unfair in the context of a regulatory agency such as the Board, which attempted to obtain guidance from the IRS, even prior to the rulemaking. Additionally, as to ACE's contention that

the finalized regulation would supersede any previously issued PLR, that is not certain at this juncture, and, in fact, the IRS' current proposal provides that as to public utility property deregulated on or before December 21, 2005, the IRS will follow holdings set forth in previously issued PLRs.

ACE has not provided any support for its assertion that the any challenge to the final regulations will have "severe and immediate consequences" to ACE and its customer, nor has it would first have to order ACE to "purposely violate the final regulations, causing a normalization violation." The Board is not, proposing that ACE violate any federal regulations, or cause a "normalization violation," Rather, the Board has concluded, for the foregoing reasons, in recognition of the changed circumstances since its 2000 Order, and after careful consideration and balancing of the interests and concerns of ACE, which, in its request for a PLR, supported and argued for the flow-through of ADITC to ratepayers, and the interests of its ratepayers, who, prior to divestiture, funded ACE's assets through depreciation charges and who, post-divestiture, continue to fund stranded costs of the generation assets, the Board believes that the flow-through issues should be considered in the pending rulemaking and the IRS, therefore, should not issue a Private Letter Ruling to ACE to address these same issues prior to the final resolution of the pending rulemaking. The Board emphasizes that proceeding in this manner is consistent with Internal Revenue Service procedures which provide that letter rulings are given when appropriate in the interest of sound tax administration, and that the IRS "will not issue a letter ruling if the request presents an issue that cannot be readily resolved before a regulation or any other published guidance is issued." Rev. Proc. 2006-6.09. While the Board concurs with ACE as to the need for the IRS' guidance as to the tax consequences of a flow-through of ADITC and EDIT to ratepayers, given the IRS' own rulemakings proposing different provisions as to effective dates of the IRS' statutory interpretations, the request at issue cannot be readily resolved before the rulemaking concludes. IRS procedures also provide that a taxpayer may withdraw a request for a letter ruling at any time before the letter ruling is signed by the IRS, Rev. Proc. 2006-7.07, and the Board FINDS that in the within context, unless the IRS will grant a request to hold the PLR request in abeyance pending the rulemaking, ACE should withdraw its PLR request.

Accordingly, pursuant to N.J.S.A. 48:2-40, and in light of the subsequent events described above that have occurred since the issuance of the 2000 Order, the Board HEREBY MODIFIES its prior directive to ACE to seek a PLR, and DIRECTS ACE to deliver to the IRS, by 5:00 p.m. on May 8, 2006, a withdrawal of its request for a PLR. However, ACE may state in its withdrawal that if the IRS agrees not to issue a PLR until after there has been a final resolution of an IRS rulemaking that addresses the tax implications of flowing through the ITC to ratepayers, including any appeals from the rulemaking, then ACE's request for a PLR shall be deemed not to be withdrawn. ACE shall simultaneously file with the Board's Secretary a copy of its withdrawal of the PLR, stating the date and time on which the withdrawal was delivered to the IRS. The Board emphasizes that its determination whether the ITC is to be flowed through to ratepayers continues to remain open pending the resolution of the issue through IRS rulemaking, and that the Board is not directing flow-through of the ITC at this time. Additionally, the Board further DIRECTS ACE to deliver to the IRS, by 5:00 p.m. on May 8, 2006, comments to be received from the BPU which will urge that the PLR request be held in abeyance, as well as comments by the RPA with respect to the proposed PLR.

The Board reserves the right to take such action as may be necessary to enforce this Order and authorizes the Attorney General's Office to take such action as may be so necessary.

DATED: 5/5/06

BOARD OF PUBLIC UTILITIES
BY:

JEANNE M. FOX
PRESIDENT

FREDERICK F. BUTLER
COMMISSIONER

CONNIE O. HUGHES
COMMISSIONER

JOSEPH L. FIORDALISO
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ATTEST:

KRISTI IZZO
SECRETARY